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FEDERAL COMMUNICATIONS COMMISSION  
WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

In the matter of

Federal-State Joint Board on  
Universal Service

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CC Docket No. 96-45

REPLY COMMENTS OF VANGUARD CELLULAR SYSTEMS, INC.

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May 8, 1996

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## **SUMMARY**

The Joint Board should recommend and the Commission should adopt a series of basic principles to be applied to all universal service plans at both the federal and state level. These principles are central to the Congressional goals of ensuring the availability of affordable universal service to all customers and of encouraging economically efficient competition in the telecommunications marketplace. Moreover, in light of the increasingly regional and national character of the telecommunications services marketplace, it is important to assure uniformity in the basic design of universal service plans.

The principles that should be adopted are as follows:

- (1) Any universal service plan should focus on providing benefits to customers rather than carriers.
- (2) Implicit subsidies should be replaced with explicit subsidies.
- (3) Subsidies should be based on incremental, not embedded costs.
- (4) The mechanism for determining subsidy payments should be straightforward.

These requirements are complementary to the principles described in Vanguard's initial comments, which also should be adopted in this proceeding. In particular, the rules should require carriers to pay only their fair share of universal service costs, without any double assessments, and any carrier that contributes to universal service support should be eligible for subsidies if it provides universal service.

The Commission also should adopt certain specific rules that are consistent with the basic requirements described above. In particular, to avoid creating new implicit subsidies any State rules limiting service deposits should be applied only to carriers providing universal service and should provide for compensation when a customer defaults on charges that exceed the State limitation on deposits. The Commission also should not require universal

service providers to serve broad geographic areas, but instead should permit them to serve in places where it is economically feasible for them to provide universal service.

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To: The Commission

**REPLY COMMENTS OF VANGUARD CELLULAR SYSTEMS, INC.**

Vanguard Cellular Systems, Inc. ("Vanguard"), by its attorneys, hereby submits its reply comments in the above-referenced proceeding.<sup>1/</sup> Review of the comments filed in this rulemaking reveals certain basic principles the Joint Board and the Commission should adopt in their deliberations on universal service. These comments identify those guidelines and provide examples of how they can be put into practice in universal service rules adopted at the federal and state levels.

**I. Introduction**

Vanguard's comments in this proceeding focused on issues affecting providers of commercial mobile radio services. In particular, Vanguard described how CMRS providers already are subsidizing universal service through their payment of interconnection charges (although interconnection charges and universal service subsidies are separate, discrete issues); urged the establishment of rules that prevent multi-jurisdictional carriers from paying

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<sup>1/</sup> Notice of Proposed Rulemaking and Order Establishing Joint Board, *Federal-State Joint Board on Universal Service*, CC Dkt. No. 96-45, rel. Mar. 8, 1996 (the "Notice"). The reply comment date for the Notice was extended to May 7 and then to May 8. See Order, *Federal-State Joint Board on Universal Service*, CC Dkt. No. 96-45, DA 96-483, rel. Apr. 1, 1996 (granting extension to May 7); Order, *Federal-State Joint Board on Universal Service*, CC Dkt. 96-45, DA 96-702, rel. May 6, 1996 (denying request for extension but extending reply comment date to May 8 pursuant to 47 C.F.R. § 1.46).

more than their fair share of universal service funding; and showed that permitting all carriers to obtain subsidy payments if they provide universal service would benefit the public interest. Nothing in the comments of other parties diminishes the importance of properly resolving those issues. Review of the comments does, however, reveal that there are other basic requirements for implementing the universal service mandates of the 1996 Act.<sup>2/</sup>

These reply comments address those requirements and provide examples of how to apply the basic requirements to specific issues. These requirements should be adopted as a matter of national policy because universal service is a national issue and because of the increasingly regional and national character of the telecommunications industry.

The following are basic principles that should govern universal service:

- (1) Any universal service plan should focus on providing benefits to *customers*, rather than to carriers. While carriers may receive universal service funding, that funding should be based on the customers they serve.
- (2) Implicit subsidies should be replaced with explicit subsidies. The 1996 Act favors explicit subsidies, and explicit subsidies would provide for a more efficient administration of universal service.
- (3) Subsidies should be based on incremental, not embedded costs. Such a standard would encourage efficient provision of universal service.
- (4) The methodology for determining subsidy payments should be straightforward. It is important to minimize the administrative burdens created by any universal service plan.

Application of these broad principles can affect the implementation of universal service. These reply comments describe how such basic requirements would apply in the context of two particular issues: customer deposits; and service areas for universal service

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<sup>2/</sup> Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (to be codified at 47 U.S.C. §§ 151 *et seq.*) (the "1996 Act").

providers. As shown below, the rules should be designed to prevent adverse consequences to universal service providers from State limitations on deposits required from new customers. The rules also should avoid arbitrarily requiring universal service providers to serve broad geographic areas.

## **II. Certain Fundamental Principles Should Be Incorporated in Every State and Federal Universal Service Plan.**

Certain fundamental principles emerge from the comments in this proceeding. These principles are sufficiently important that they should be incorporated into every universal service plan adopted under the 1996 Act, both at the federal level and by States when they fulfill their obligations under new Section 254 of the Communications Act. It is vital for the Joint Board and the Commission to adopt *national* standards implementing these principles so that they will be applied evenhandedly across the country. While the States should be able to adapt their individual universal service plans to local needs within the context of the national standards, the States should not be permitted to ignore or supersede federal requirements. Moreover, the significance of national uniformity is likely to increase in the future as more and more carriers provide service on a regional or national basis.<sup>3/</sup>

The four principles discussed below, in addition to the principles described in Vanguard's initial comments, should be at the core of the nationwide policies governing universal service. Each is consistent with the underlying goal of the 1996 Act to benefit

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<sup>3/</sup> Given the importance of universal service issues to the development of competition, the Commission has the power to mandate specific requirements, under both its power to prevent States from adopting universal service rules that are inconsistent with the federal rules and its power to preempt State regulation that impairs competition. 47 U.S.C. §§ 253, 254(f).

consumers by increasing competition in telecommunications services. Collectively, they also promote efficiency, lowering the costs of universal service for carriers and customers alike.

**A. Universal Service Plans Should Focus on Providing Benefits to Consumers Rather than Carriers.**

The purpose of Section 254 and of any universal service plan is to meet specific customer needs. While carriers provide the service that meets those needs, any plan that focuses on carriers rather than consumers will be inefficient and may not achieve the goal of making affordable telephone service available to all consumers.

While it should be obvious that universal service plans should be designed with customers in mind, that has not always been the case. For example, some state proceedings have been premised on the question of how to assure that carriers now providing universal service are made whole. This approach is not consistent with a competitive environment in which carriers succeed not because they are entitled to special subsidies, but because they provide better or more affordable service.

Several commenters highlight the importance of maintaining a focus on customers. *See, e.g.,* Comments of MFS at 13-15; Comments of WinStar at 8. As these commenters explain, the only way to achieve this goal is to require universal service subsidies to be targeted to eligible customers, with the subsidies following the customers as they change carriers. Comments of ALTS at 3.

Tying subsidies to customers would have several important benefits. First, it encourages competition because subsidized customers are equally valuable to all carriers. By contrast, if only the incumbent carrier (or a low bidder in a “universal service auction”)



were eligible for a subsidy, then the incentive for competitors to serve the subsidized customers would be minimal at best.<sup>4/</sup>

Increasing competition also is likely to reduce the actual amount of the universal service subsidy. If there is competition for universal service customers, both competitors and incumbents will have strong incentives to reduce their costs and increase their efficiency so they can attract subsidized customers. As costs go down, the subsidies also will be reduced, lessening the burden of payments into the universal service fund. At the same time, consumers will benefit, both directly from reduced prices as competition takes hold and indirectly from the reductions in universal service payments by the carriers that serve them.

Another important implication of this principle is that all potential providers of universal service should be able to obtain subsidies for the customers they serve. As Vanguard and several other commenters noted, the rules governing universal service should be technology neutral and should focus on the actual service being received by consumers. *See, e.g.,* Comments of Vanguard at 5-7; Comments of 360° Communications at 4. For this reason, cellular carriers and other CMRS providers should be eligible for universal service fund support.<sup>5/</sup>

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<sup>4/</sup> In practice, a competitor will serve any customer only when its expected revenues exceed the cost of serving the customer. If subsidies are not portable, then the expected revenues for subsidized customers will be only the amount the customers pay for service. If subsidies are portable, on the other hand, the expected revenues will be equal to the amount the customers pay for service *plus* the amount of the subsidy. This obviously is a much more attractive proposition.

<sup>5/</sup> *See* Comments of CTIA at 3. One important reason to maintain technology neutrality is to give consumers in rural areas universal service alternatives. While NECA suggests that competition may not be viable in rural areas, that is not the case. Comments of NECA at 8. Cellular carriers and other CMRS providers can serve rural areas at relatively

(continued...)

**B. Implicit Subsidies Should Be Replaced with Explicit Subsidies.**

To the extent that universal service is addressed in today's telecommunications marketplace, much of the financial support is implicit rather than explicit. Many commenters support the statutory preference to change this system to one of explicit subsidies. *See, e.g.,* Comments of Southwestern Bell at 3; Comments of NCTA at ii; Comments of Netscape at 8-9. Use of explicit subsidies is consistent with the 1996 Act and encourages efficiency. The Joint Board and the Commission should, therefore, adopt as a principle that all universal service subsidies must be made explicit.

Today, some subsidies are funded through explicit carrier contributions, but in practice most subsidies for basic services are funded implicitly by charging much more than cost for some services. As Vanguard described in its comments, one of the chief examples of an implicit subsidy is the current system of CMRS interconnection charges, which are assessed at rates that exceed cost by as much as \$1.03 billion a year. Comments of Vanguard at 4. Other forms of implicit subsidy exist as well.<sup>6/</sup>

While the current system depends on implicit subsidies, the 1996 Act expresses a preference for explicit subsidies. Indeed, new Section 254(e) of the Communications Act

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<sup>5/</sup> (...continued)

low cost, so they may be the most logical competitors to rural telephone companies. *See* Comments of Vanguard at 7-9. In fact, Vanguard already serves some rural areas under the Commission's rules for Basic Exchange Telephone Radio Service.

<sup>6/</sup> The Commission should examine LEC claims of subsidy carefully, however, because the LECs have a significant incentive to exaggerate the extent of implicit subsidies. Indeed, there is evidence that some claimed subsidies, such as the subsidy of residential service, do not actually exist. *See Washington Util. and Transp. Comm'n v. U S WEST Communications, Inc.*, Dkt. No. US-950200 (Wash. Util. and Transp. Comm'n 1996) at 10 (finding that existing residential local service rate covers costs).

states that any universal service support “should be explicit.” 47 U.S.C. § 254(e). The Conference Report on the 1996 Act confirms this, stating that “[i]n keeping with the conferees’ intent that all universal service support should be clearly identified, this subsection [254(e)] states that such support should be made explicit . . .”<sup>7/</sup>

There are good reasons for this Congressional preference for explicit subsidies. First, the actual amount of subsidy required can be identified only if the subsidy is explicit. The current implicit subsidy system has made it impossible to evaluate LEC claims of billions of dollars in annual subsidies, let alone to verify the specific amounts.

Second, explicit subsidies encourage efficiency. It is easier to scrutinize explicit subsidies to determine whether they are excessive. In addition, universal service subsidies must be made explicit if they are to be available to competitors. As described above, making subsidies available to competitors is an important way to encourage efficient provision of universal service and to reduce the amount of subsidy that is needed.

Third, explicit subsidies lessen the danger that universal service policies will be intermingled with implementation of other policies, such as interconnection charges. As the CMRS interconnection proceeding shows, unless subsidies are made explicit and separated from other charges, incumbent LECs will have powerful incentives to claim harm to “essential” subsidy flows whenever the Commission or a State attempts to address uneconomic or monopoly pricing.

The combination of the Congressional mandate and the benefits of explicit subsidies is more than sufficient to warrant a policy requiring all universal service subsidies to be made

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<sup>7/</sup> Conference Report at 131.

explicit at both the federal and State levels. The Joint Board should recommend such a policy and the Commission should adopt it.

**C. Subsidies Should Be Based on Incremental, Not Embedded Cost.**

Both State and federal regulators must consider how to determine the costs of providing universal service. As indicated above, the current system of implicit subsidies makes doing so a difficult task. There is, however, a better approach to making that determination, as suggested by MFS and others. The Joint Board should recommend and the Commission should require all universal service subsidies to be calculated on the basis of incremental, not embedded costs. *See* Comments of MFS at 8. Doing so will increase efficiency in the provision of universal service. Incremental pricing is so important to basic universal service policy that it should be required at both the federal and State levels.

As shown above, there are significant benefits to policies that promote efficient provision of universal service. These benefits include encouraging economically efficient universal service offerings by new entrants and reducing the size of the subsidy pool.

Adopting an incremental cost model for calculating universal service subsidies will have the same effect. An incremental cost approach, using total service long run incremental cost or a similar costing methodology, will base the subsidy for universal service on what it costs to provide service today, using today's technology, not what it would cost to use technology that might have been deployed two or three decades ago. Consequently, carriers will have incentives to use current technology whenever possible to provide universal service. Ultimately, the use of current technology will create significant efficiency gains for those carriers and for the consumers who use their services.

While some carriers may argue that they should be entitled to use an embedded cost model, there is no requirement that the Commission or the States adopt any particular model for universal service funding. The Joint Board and the Commission also should recognize that embedded cost does not necessarily reflect the amounts that carriers actually expect to recover. Many carriers, and particularly Bell Operating Companies, already have taken write-downs on their financial books because they do not believe they will be able to recover the full investment in their embedded plant. Consequently, the embedded costs remaining on their regulatory books are effectively a regulatory fiction, rather than a reflection of the carriers' true expectations.<sup>8/</sup> In this context, the use of embedded costs to calculate universal service subsidies would be unreasonable.

The use of incremental costs to determine universal service subsidies is critical to the proper implementation of the 1996 Act's universal service provisions. The costing methodology will have a profound impact on the amount of the universal service fund and the ability of new competitors to provide universal service effectively. As a result, the final universal service rules should require both federal and State universal service funding to be based on incremental cost methodologies and should not permit regulators to use embedded costs in their universal service calculations. Such uniformity will serve the public interest and foster the development of local telephone competition. Moreover, the cost standard is sufficiently important that it should be determined uniformly at the federal level, rather than on a state-by-state basis.

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<sup>8/</sup> This is an important distinction, because carriers are entitled to recover only such costs as are consistent with "reasonable investment-backed expectations." *See Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978). Investor expectations normally would be reflected on a company's financial books, not its regulatory books.

**D. The Mechanism for Determining Subsidy Payments Should Be Simple.**

The final principle that should be applied to any universal service plan is that the mechanism for determining subsidy payments should be as simple as possible. A straightforward payment mechanism, such as a fee assessed on a per-customer or per-minute basis, would reduce burdens on carriers and would be consistent with Congressional intent to avoid overly burdensome regulations. Thus, the Joint Board should recommend and the Commission should adopt national standards that require all plans to calculate carriers' payment obligations on the same basis, either per customer or per minute of traffic.

As a general rule, the Joint Board and the Commission should try to simplify and reduce the administrative burdens of universal service obligations whenever possible. Some regulation is unavoidable if the universal service rules are to comply with the requirements Congress set out in the 1996 Act. Nevertheless, there is no reason to impose any costs on telecommunications carriers beyond the minimum required to achieve Congressional universal service goals. This is particularly true of administrative costs, which do not benefit either consumers or carriers. Thus, it is appropriate for the Commission and the States to minimize the administrative burdens of universal service whenever possible.

Reducing the administrative and regulatory burdens of universal service also is consistent with the underlying goals of the 1996 Act. Congress did not intend to increase administrative burdens on regulated entities and, in fact, provided for the Commission to act to reduce those burdens whenever it was reasonable to do so. *See, e.g., 1996 Act, Title IV.*

Payment requirements based on the number of customers a carrier serves or the number of minutes of traffic carried would be the most administratively simple mechanism

for carriers to implement, and should therefore be adopted. Carriers routinely maintain customer records with information necessary to calculate a universal service fund payment using either the number of customers or the number of minutes. These allocation methods also would allocate the universal service subsidy fund payments fairly among telecommunications services providers, assuring that no provider would be unduly burdened.

The universal service payment should not be based on carrier revenues. While revenue-based calculations might at first might seem attractive, they would unfairly burden resellers and others who make payments to intermediate carriers or, if the Commission were to adopt calculation methods that accounted for payments to other carriers, would be complicated to administer and subject to dispute. In either case, calculating support payments on the basis of the number of customers served or the number of minutes of traffic would avoid the problems associated with revenue-based payment schemes.

**III. There Are Certain Specific Provisions, Consistent with the Fundamental Principles of any Universal Service Plan, that Should Be Reflected in the Final Rules.**

The fundamental principles described above and in Vanguard's initial comments should govern the broad framework for universal service. There also are specific provisions that should be incorporated into any universal service plan adopted at the federal or state level. As described below, the Joint Board and the Commission should provide guidance on the treatment of deposits made by customers receiving service under universal service plans and should not require carriers to offer universal service over broad geographic areas.

**A. The Rules Should Provide Guidance on Service Deposits to Prevent Unreasonably Burdening Carriers.**

Some commenters suggest limits on service deposits that consumers make prior to obtaining telephone service. *See, e.g.*, Comments of Pennsylvania PUC at 22; Comments of Northern Mariana Islands at 19. While Vanguard does not oppose efforts to make it easier for consumers to obtain telephone service, it is also important to avoid unreasonably burdening carriers in the process. In the case of deposit limitations, specific rules are necessary to comply with the Congressional direction to adopt explicit subsidy mechanisms.

Limitations on consumer deposits lead to implicit subsidies because they result in a mismatch of costs and revenues. First, if limits on deposits apply to all carriers, regardless of whether they offer universal service, then no carrier will be able to adjust its deposits freely to account for differences in creditworthiness or usage patterns, and it is likely that, on the whole, deposits will be inadequate. This will require carriers to make up for the additional expenses of lost deposits through their rates, creating an implicit subsidy running to those customers who could not have afforded a higher deposit than permitted by a deposit limitation. Even if the deposit limitation applies only to carriers providing universal service, they will be subject to the same economic forces, with the same result.

There are two solutions to this problem. First, any rules limiting deposits should be applied only to carriers providing universal service. There is no reason to burden other carriers with deposit limitations, and narrowing the number of carriers subject to such a requirement also will reduce the amount of any implicit subsidy.

Second, if a universal service plan at either the federal or State level includes a limitation on consumer deposits, it also should be required to provide for compensation to



carriers in the case of customer default. When a customer defaults, the carrier should be reimbursed for the difference between the amount of the permitted deposit and the charges accrued by the customer, up to the amount of the deposit that otherwise would have been required. In this way, the burden of the deposit limitation will not be borne by the universal service carriers, but will be accounted for explicitly in the universal service funding mechanism.

It is important to note that this is an example of how the Joint Board and the Commission can provide important guidance to the States without eliminating the discretion of State commissions to tailor universal service plans to their individual needs. The guidelines described above would not prevent States from limiting deposits, or from determining what limitations to adopt, but merely set parameters to follow in making those determinations. This approach preserves the important State role in universal service while ensuring that all universal service plans will be fundamentally consistent across the country.

**B. The Commission Should Reject Any Proposal to Require Carriers to Offer Universal Service in Broad Service Areas.**

At least one commenter suggested that the Commission should limit universal service support to carriers that are willing to serve “entire” service areas. Comments of CITA at 6. This proposal raises a series of definitional and economic issues that make it entirely untenable. Consequently, the Joint Board and the Commission should reject this proposal and, instead, should permit carriers to provide universal service in any area within their service areas.

The first problem with requiring carriers to serve an “entire” service area to be eligible for universal service funding is definitional. Determining the appropriate service

area may be difficult in many cases and, in other cases, may not lead to a meaningful result. Equally important, different carriers' service areas already differ significantly. For instance, in many Vanguard markets its service area is much larger than some local carriers and much smaller than Bell Atlantic's or NYNEX's service area.<sup>9/</sup> These differences in service areas will be exacerbated when PCS providers and competitive local exchange carriers begin to provide service, because their service areas will only rarely match existing service areas.

Even assuming that a satisfactory definition of service areas could be found, there is no good reason to require carriers to provide universal service throughout their entire service areas. In practice, a carrier may be the least cost provider in only part of its territory. A cellular carrier such as Vanguard may, for instance, have lower costs than the LECs serving the rural portions of its service area and higher costs than the LECs serving the urban areas.

This could be true, for example, in Vanguard's Northeast Pennsylvania market, which includes the urban area of Scranton and rural areas near federal parkland. Permitting Vanguard to provide universal service in the rural areas of the Northeast Pennsylvania market would give consumers a choice of carriers for local phone service, would encourage efficiency by the landline carriers serving that area and ultimately reduce the subsidy required for universal service. If Vanguard were required to provide universal service in downtown Scranton as a prerequisite to providing service in the rural parts of the market, the economics of providing universal service could change drastically, and could prevent Vanguard from providing universal service to *any* customers. In light of the pro-competitive mandates of the 1996 Act, this plainly is not the result that Congress intended. Thus, the

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<sup>9/</sup> For that matter, Vanguard's actual service areas also differ from the actual service areas of the other cellular licensees in its markets.

Joint Board and the Commission should adopt policies that permit carriers to provide universal service wherever it is economically reasonable for them to do so, without any requirement to provide universal service over a broad geographic area.

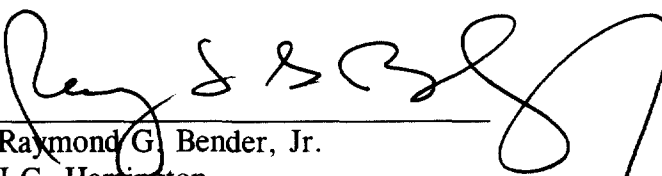
#### **IV. Conclusion**

In its comments and these reply comments, Vanguard identifies important principles that should be applied to all universal service plans. In a marketplace that increasingly requires a regional and/or national presence, it is critical that the Joint Board and the Commission define basic national policies to govern the implementation of universal service plans both at the federal level and in the States. Adopting the principles recommended by Vanguard will encourage efficiency and help achieve the underlying goals of the 1996 Act to encourage the growth of competition and ensure that consumers obtain universal service at

affordable rates. For all these reasons, Vanguard Cellular Systems, Inc., respectfully requests that the Joint Board recommend and the Commission adopt rules that are consistent with its comments in this proceeding.

Respectfully submitted,

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May 8, 1996

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\*Via Hand Delivery.